



News Release

Media Relations Office

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Tel. 202.622.4000

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**IRS MOVES TO ENSURE FAIRNESS OF TAX SYSTEM;
RESEARCH PROGRAM WORKS TO INCREASE COMPLIANCE
PROGRAM EFFECTIVENESS, REDUCE BURDENS ON TAXPAYERS**

WASHINGTON – The Internal Revenue Service is proposing to reestablish a key component of the agency's ongoing compliance effort to help ensure fairness for America's taxpayers. The updated program is designed to accurately measure tax compliance while minimizing the need to contact taxpayers during the process.

The agency's National Research Program (NRP) is developing innovative approaches to measure taxpayer compliance with the tax law. Several key elements stand out about this effort:

- It will be far less intrusive and burdensome on taxpayers than previous compliance studies.
- It will help the IRS build better compliance programs to more effectively catch tax cheating and help ensure all taxpayers pay a fair share.
- It will help reduce audits of taxpayers who filed an accurate return by at least 15,000 tax returns a year.

"Honest taxpayers shouldn't have to shoulder the burden for those who don't pay what they owe," said IRS Commissioner Charles O. Rossotti. "This approach will give us the tools we need to help ensure the fairness of the American tax system."

"The IRS is working smarter," Rossotti said. "We have found new ways to use existing information to measure tax compliance. The process is substantially less intrusive on taxpayers, but it will help us catch tax cheating and improve tax administration."

As part of ongoing compliance operations, NRP will focus on measuring three key areas of tax administration – filing compliance, payment compliance and reporting compliance. A key element involves measuring the accuracy of reporting information on tax returns. The IRS has overhauled the reporting component to minimize disruptions to taxpayers during the study.

In the past, the IRS relied heavily on time-intensive, "line-by-line" audits for establishing a baseline measure of reporting compliance. This time, the IRS will shift more of the burden onto itself – and away from taxpayers – by using more information

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that it has already collected. This will help reduce the intrusiveness of audits needed for the program.

NRP will not result in additional audits of taxpayers, and the IRS will use existing audit resources to implement the program.

In addition, the vast majority of those selected for audit in the program will answer questions about only a limited portion of the tax return, which will sharply reduce the amount of time and burden for taxpayers. Some taxpayers won't be contacted at all, while others will participate by mail.

There will be face-to-face audits in NRP, but there will be much fewer than in previous studies. Generally, this portion of the NRP audits will be comparable to a regular IRS audit. That's a change from earlier studies, where the exams usually took twice as long as regular audits.

"Ultimately, this project will help all taxpayers by giving the agency timely, accurate information about tax compliance," Rossotti said. "This information will allow the IRS to replace outdated audit formulas and develop compliance efforts targeted at the tax returns most likely to have errors rather than those from honest taxpayers."

Taxpayers will benefit from redesigned forms, improved communications, suggested tax law changes and enforcement focused on non-compliant taxpayers.

The NRP study will give the IRS a much-needed road map for selecting future audits – a crucial point because audits of compliant tax returns are unnecessary and burdensome for taxpayers and costly for the IRS.

In order to estimate which returns have the highest likelihood of error, the IRS will use information from these audits to update existing screening techniques to select tax returns for audit. When these screening techniques are up to date, the IRS avoids auditing taxpayers whose returns are accurate and helps the IRS audit those returns that are truly in error.

However, the IRS has not conducted updated research on the distribution of errors in returns for more than 13 years, a period when the economy and the tax law have changed dramatically. By not updating this information, the IRS has less ability to direct its audits and other compliance activities with accuracy and precision, which reduces the effectiveness of these activities and increases the cost to the honest taxpayer. This is reflected in the number of "no change" audits increasing steadily from less than 21 percent in 1993 to more than 27 percent in 2005.

With updated information, the NRP effort will prevent at least 15,000 needless

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“no change” audits each year. “No change” audits are instances where the IRS audits a taxpayer but makes no change to their tax return.

In order to improve the audit selection process and reduce taxpayer burden, the NRP in September 2002 will begin reviewing a small, statistically valid sample of individual returns from the 1040 family.

There are fundamental differences between NRP and previous efforts, including the numbers of taxpayers involved in audits. For example:

- For the tax year 1988 returns, there were 54,000 of the “line-by-line” audits.
- Starting in September 2002, NRP will begin working on less than 50,000 audits out of 132 million individual returns filed. There are four categories of audits included in this, ranging from no contact with taxpayers to scaled-back audits that will require less taxpayer substantiation than previous studies.

The new NRP process will gather information through four main categories:

- No IRS contacts. About 8,000 returns will be checked relying solely on information already provided to the IRS. No additional taxpayer contact will be required.
- Correspondence with taxpayers. These will be less intrusive correspondence exchanges with taxpayers -- rather than the old standard of sit-down audits. About 9,000 returns will be included in this process. In some of these cases, taxpayers would have heard from the IRS anyway in our normal course of matching information already received by the IRS.
- Less intrusive audits. Instead of the old “line-by-line” auditing approach, the IRS will gather more information beforehand from agency records and focus only on select parts of approximately 30,000 returns. These partial audits will be less time-consuming and costly for individual taxpayers. Under the old process, audits could take twice as long as a regular IRS audit. Under the NRP approach, they should be comparable to a regular audit.
- Calibration audits. These will consist of about 2,000 audits that will check each line of the return. In a major change from earlier studies, these will not require explicit “line-by-line” substantiation by taxpayers of each part of the return so they will not be as burdensome.

Even without NRP, IRS employees would still review about the same number of tax returns. The IRS will use existing resources in its audit program to implement NRP,

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and the sample will account for only about 1.1 percent of the total audit-related contacts planned for the year.

“This is a smarter, common-sense approach that makes it easier for the taxpayer in the short run,” Rossotti said. “In the long run, the study will give us valuable information that will keep us from needlessly bothering honest taxpayers with audits and encouraging greater tax compliance.”

“This innovative approach will help us catch cheating and ensure everyone pays a fair share,” Rossotti said.

The IRS will work closely with tax practitioners, members of Congress and other key stakeholders to finalize the project.

In the months ahead, the IRS will begin work on the other two elements of NRP.

For filing compliance, the agency will estimate the individual income tax that is not timely paid that is associated with required tax returns that are not timely filed.

For payment compliance, the IRS will measure the percent of individual income tax on timely-filed returns that was paid on a timely basis. IRS records will be used to produce these measurements.

Later, the agency will add reporting and payment compliance measures associated with corporation income tax and other taxes, such as employment and excise tax.

The three components of measuring compliance will help provide new, more accurate estimates of the tax gap, which is the difference between total tax liability and tax paid voluntarily and timely. The gross tax gap, which includes amounts associated with non-filing, underreporting and underpayment of all taxes (individual, corporate, employment and estate) is estimated at \$278 billion for tax year 1998.

This ongoing effort will help the IRS provide a newer, more accurate measure of the tax gap. It will also help the agency narrow the tax gap by better focusing enforcement research and encouraging more tax compliance. Just a 0.1 percent improvement in the tax compliance rate would increase revenue by more than \$1 billion a year.

“This approach symbolizes how we will do business in the new IRS,” Rossotti said. “We want to work smarter to minimize headaches and costs for taxpayers and maximize compliance with the tax laws.”

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